

Washington State Tax Structure Study

Committee Meeting Minutes June 14, 2002

Committee members present:

- John Beck
- Lisa Brown
- Neil Bruce
- Jack Cairnes
- Dick Conway
- Bill Gates, Sr.
- Lily Kahng
- Jim McIntire
- Debbe Sanders
- Hugh Spitzer
- Gary Strannigan

The June 14, 2002, Committee meeting was held in the Walker Ames Room, Kane Hall, University of Washington, from 8:30 a.m. to 4 p.m.

Welcome

Bill Gates welcomed the Committee members.

The minutes of the May 10, 2002, Committee meeting were approved as submitted.

Statement of Workshop Purpose

Bill Gates and Hugh Spitzer talked about the purpose of the workshop.

Review Principles for Evaluation

Bill Gates reviewed the principles for evaluating our present tax system and proposed tax alternatives: stability, long-term adequacy, equity/fairness, economic neutrality, interstate competitiveness, simplicity, and transparency. Bill commented that in his view the question of adequacy is mainly a political question and is something that the Legislature could consider to be one of its major problems over the next several biennia.

Evaluation of Current Tax System

Each Committee member was given the opportunity to comment on the research findings about the current tax system and the key problems that the Committee should address.

John Beck: The B&O tax is rated low in terms of visibility but it is not really transparent. It has a pyramiding effect because it is a tax on gross receipts at all stages of the production process. There is a penalty for being nonvertically integrated for small businesses, so it violates the neutrality principle. The sales tax is the most regressive, the most volatile over the business cycle. It violates the neutrality and horizontal equity principles. I would rate sales tax low on

visibility. People may be aware of the tax rate but they are not aware of how much they pay in sales tax during the year. The property tax is a stable revenue source. It is not regressive over a lifetime and the tax burden is visible. I would rate the property tax fairly highly.

Lisa Brown: Agrees with Bill Gates that the adequacy issue is not one that this Committee can grapple with. One major concern is the regressivity of the overall system. The B&O tax sticks out like a sore thumb-- 50 years from now will we still be the only state to have a B&O tax on gross receipts or are we going to do something about it? Over the course of the business cycle it can be extremely burdensome for businesses.

Neil Bruce: The tax system has essentially remained in its basic form for 70 years. With respect to adequacy, he agrees that the Committee's job is not to tell the state to raise or lower taxes. However, there is another interpretation of the adequacy issue that does matter to the Committee. We have a three-legged stool -- B&O tax, property tax, and sales tax. The thickest leg of the stool is the sales tax and there are concerns about the long-term viability of the sales tax. When we have a system that is so based on people making purchases, the long-run adequacy of this important leg of the stool is something we need to worry about. With respect to stabilization, he does not think the evidence presented shows that the Washington State tax system is less stable than other states' systems. With respect to fairness, the sales tax seems to be unfair because it puts a disproportionately higher tax burdens on low-income people. We do not have information on what the people of Washington actually believe about the fairness of the tax system. Deviations from economic neutrality pose hidden burdens on the people of the state. Transparency -- most people in the state are unaware of the amount of taxes they pay. Either it is hidden like the B&O tax or it nickels and dimes them like the retail sales tax. One reason why the three-legged stool survives is because taxpayers do not perceive the tax system. I have a divided view of whether it would be better for us to have a transparent tax system.

Jack Cairnes: Challenges the regressive sales tax presumption. Thinks the sales tax is pretty fair. Our goal is not to add more taxes, it is to stay neutral. We need to take a close look at our property tax, the death tax, and affordable housing. We need to talk about tax incremental financing (TIF) because it will help our cities.

Dick Conway: Has concluded that our tax system is flawed and we are headed for trouble. The fundamental issue is one of adequacy. Desirable properties of our tax system: 1) it generates taxes that essentially grow along with the economy, and 2) our tax system should look like all other tax systems. With no income tax it is very regressive. Our heavy reliance on the B&O tax creates a high direct tax burden on businesses and makes Washington look unfriendly to new businesses. The reliance on the sales tax makes our system very volatile. That has created severe problems for state and local governments. A related problem is our setting of tax policy by initiative. We need to talk about a rainy day fund. Broaden our purview and at least say something about adequacy, initiatives, and the rainy day fund.

Lily Kahng: Washington State residents have a different relationship with taxes and government. They are more suspicious of government, are less willing to pay taxes, and believe they should be able to do whatever they want without the interference of government. That means that government has to do a better job for its residents if we are going to ask them to accept a new kind of tax system. Doesn't think the tax system is particularly attractive. There are some serious problems with the sales tax -- the problem with volatility. A rainy day fund could ameliorate that problem. Concerned about the regressivity of the sales tax. Home ownership has

tax advantages from a federal and state tax standpoint. As long as home ownership is tax subsidized home prices will continue to escalate, and it is those people at the bottom who are not able to take advantage of those subsidies. In 1986 the federal deduction for sales taxes was repealed and, in contrast, the federal deduction for income taxes was retained. If we are to impose deductible taxes at the state level we can raise more state revenues without costing our residents anything more.

Debbe Sanders: People like sales taxes because you only pay a small amount each time you make a purchase. They like that it is not transparent and they feel that they are in control because they can decide whether or not to buy something. They like taxes with a low rate. There is a problem with the regressivity, but people don't seem to mind that because they feel as if they are in control and it is a little amount each time they pay the taxes. A state that relies on only three taxes is doing itself a disservice. We need a broader tax base. We need a portfolio of stable taxes that can cover discretionary expenditures and taxes that adjust for nondiscretionary expenditures.

Gary Strannigan: Adequacy is not an issue for this Committee except that we do need to pay attention to the long view of what our tax system is going to do. People like the taxes that don't come in one big bill. Property taxes are very consternating particularly for people who are on fixed incomes. People don't have any feel for the value they are getting for their investment in government. This state should ask the federal government to enact laws to allow us to deduct the sales tax proceeds. Have a rainy day fund with triggers as to when the money should be used. There may be permanent tax cuts but spending increases are equally as permanent. On the economic neutrality side we can try to make the tax code less instrumental in influencing the behavior of people in the marketplace but in the end those people will find their way back to the Legislature. Give the people some mechanism to assess how much they have paid in taxes and they can link that to how they feel the government is doing.

Jim McIntire: The findings are a pretty good indictment of a system that needs to be reworked. It is time to be visionary about our tax system -- challenge the public to think seriously about what kind of tax system we should have that would provide the most equitable way to finance state services. There are many lower income people in our state who are being overtaxed. Is that because of the tax system or the government is spending too much? We are not spending much differently than any other state but we are taxing low income people much more than are other states.

Hugh Spitzer: Our tax system is too volatile. There are basic services that need to continue even when the economy is down, but our tax structure does not enable us to continue basic funding for basic services. We should try to design a package of taxes that aims to have a volatility at about 1.0. We should have a constitutionally entrenched rainy day fund that forces us to save in good times and automatically releases the money in bad times. Adequacy—the increase in total personal income in this states does increase demands for goods and services that are provided by government. So we need to keep up with income and productivity. Debt is not an option in this state and that is good. In adequacy, local governments are particularly hard hit. Unlike state government, they don't have control over the tools to pay for services. Economic volatility—we haven't seen much evidence that the overall tax structure makes a lot of difference in business development, siting and retention. There needs to be a national and international system to pay sales tax on purchases so you don't escape paying sales tax by buying from another country via the Internet. There is no justification for low income people paying such a huge amount in taxes.

They are not getting more than people who are paying a lot of money. People who have a lot of assets and property ought to pay more because government is protecting their property and their rights more than it does other people, but this is not a popular view. Most people seem to like the retail sales tax because it appears fair. We need to educate people on some of the peculiarities of who is paying more and who is paying less. Is it fair that the agriculture sector pays half of what the transportation sector pays? Administrative simplicity---we should try to get rid of many of the weird little taxes, odd exemptions and exclusions -- they are hard to manage and hard to justify. We should get a federal deduction for the sales tax.

Bill Gates: Is concerned about regressivity -- it is utter nonsense that the low income person pays so much more in taxes. The federal government is taking the estate tax away from us -- we need to see that that loss does not occur. Internet sales are a growing factor in the economic life of this country. People that provide services should collect sales tax. The rate could be reduced if we could extend sales tax to some services. There is not a realistic way to tax intangibles in this state. The property tax is simple. There should be some kind of rider on the federal income tax. People prefer an unfair system because of the anomaly of not knowing how much they pay and paying it in such small amounts that it doesn't seem like much.

Replacement Alternatives

John Beck and Neil Bruce spoke about various replacement alternatives such as a value-added tax (VAT) on goods and services as a replacement for the B&O tax only and as a replacement for both the B&O tax and the retail sales tax, and business and personal income taxes.

Incremental Alternatives

The Committee discussed incremental tax alternatives: user fees and dedicated taxes, business incentives, taxes on property and assets, sales and use tax, B&O tax, local fiscal capacity, and a rainy day fund.

Roundtable Discussion

Each Committee member was given an opportunity to tell what alternatives they were most intrigued by and would like to focus on.

Gary Strannigan: Intrigued by the VAT. The VAT does present a lot of problems in educating lawmakers and the public on how it works. It addresses the pyramiding issue with respect to B&O, and if you can get it to address the exemption for food, that would address some of the regressivity problems.

Debbe Sanders: Most interested in the invoice credit method of the VAT because that gives an easier way to audit. Thinks it would actually cost less administratively because most of the administration is done by the intermediaries as opposed to the accounting being done by the Department of Revenue. If looking at the personal income taxes, would prefer more of a flat tax with one rate and some kind of a standard deduction or personal exemption.

Jim McIntire: Thinks we should pursue a VAT. The invoice method addresses some of the issues of regressivity. It is a pretty straightforward kind of thing to do. Income tax -- would prefer a personal, flat rate income tax with a relatively high income threshold rather than having

a standard deduction. Over time an income tax might give us the basis for shifting the dependence on sales tax to another source.

Lily Kahng: Intrigued by the VAT or the comprehensive B&O tax. Likes the idea of a personal income tax. It would have to be carefully tailored to comply with constitutional constraints and political constraints. It might have a better chance of going somewhere if it would replace one tax or maybe both taxes. We need an income tax to counteract the regressivity of our sales tax.

Dick Conway: Would like a thorough analysis of the income tax to see how our tax system stacks up to the average tax systems that other states have and to figure out our advantages or disadvantages relative to other states. Would like to look more at user fees. However we structure our taxes, we are not going to solve the volatility problem.

Jack Cairnes: Feels the rainy day fund is worth pursuing if it is protected and is meaningful. Doing something with the state portion of the property tax would be good if it could be done without shifting any taxes. Would like the death or pickup tax to comply with what the federal government is doing.

Neil Bruce: The base of our state tax system is far too narrow. It is not a good idea to have high tax rates on a narrow base. The best thing for the state to look at is a flat rate tax on personal income. If we can't get an income tax, we should look at the options to broaden the tax base and lower the rate through a unified goods and services tax or a true comprehensive business and occupation tax. If these fail, in a time of fiscal tightness projected into the indefinite future, we will have to rely more on user fees where they are appropriate. If we keep the retail sales tax, look at extending it to consumer services. Consumer services have been the most rapidly growing part of spending and that's why the sales tax revenue can't keep up. Retargeting business incentives to see whether they still serve their purpose is a good idea. We should seriously look at lowering the state's share of the property tax in order to create tax capacity for local governments. In exchange, perhaps local governments could give up other taxes which create a tax jungle of different rates and make administration of the tax system so difficult.

Lisa Brown: Would like to see one of the proposed tax packages have low rates, broad bases and a variety of taxes. Definitely replace at least the B&O tax with something else and lower and broaden the retail sales tax, or possibly replace both of them.

John Beck: Thinks we should pursue some version of the VAT to replace at least the B&O tax. As a state with no income tax we are not in a position to bargain because we can't give a reciprocity agreement. The harmonization issue is one advantage of having some kind of state income tax. Look at corporate income tax as a complement to the personal income tax to prevent people from using some kind of corporate business structure to shelter their personal income. As a replacement to a business tax the corporate income tax is undesirable, but as a complement to a personal income tax, it could play a useful role.

Debbe Sanders: A rainy day fund is a good idea -- one that is constitutionally entrenched with formulas to determine when deposits would be made to the fund and when money would be disbursed from the fund.

Lily Kahng: For a personal income tax, we should run numbers not only of what it will raise in revenue but also how much taxpayers will save by itemizing so that will illustrate the benefits of

the federal deduction. A tax on property including intangibles is a huge base that is untaxed. We could propose an exemption or reduction in property taxes for a first-time homebuyer. Cautioned that the way the whole budget process works could be distorted by the use of a rainy day fund.

Jack Cairnes: Tax increment financing would expand the tax base. It does work and it is a good way to broaden the base.

Hugh Spitzer: Likes the basic concept that the Committee report contains a bunch of different tools. We do want to come up with some specific packages out of the tools that we outline, making clear that legislators can pick and choose what they want. One should be an incremental package, and one should have a tax like the goods and services tax which is a big change and one should be balanced. Thinks a balanced package would have more taxes, a broader base, and noticeably lower rates. Likes the invoice method VAT. Would like to replace the B&O with the VAT but would have to find a solution to its effect on local governments. Feels that we have to get serious about the rainy day fund -- have a committee to determine what the triggers would be and try to draft it. In a balanced package we need to keep the sales tax but at a much lower rate, perhaps cut it in half. A lot of different taxes are needed for stability because if one is doing bad, another is doing better.

Bill Gates: There aren't many uses to impose a user fee for. Many user fees are paid by the guy who is working for a living and people in households. Is intrigued about reimbursing businesses for collecting the sales tax. A proposal for a graduated personal income tax should be submitted to the people. Some legislators will probably cut that down, but if you want to think in terms of the best thing for this state, we should have a graduated income tax in this state.

Jim McIntire asked about the possibility of producing a video to educate the public about our current tax system and the various alternatives.

Wrap Up

It was decided to invite the Advisory Group members to the July 12, 2002, meeting and give them an opportunity to comment on the proposed alternatives. They will be asked to notify the Department of Revenue ahead of time so that we can schedule the appropriate amount of time for their comments.

Bill will meet with Hugh, Lily, and Jim before the next meeting to discuss the format for the written report.

The idea of an educational video will be discussed at the July meeting. DOR staff will find out what it would cost, what form it would take, etc., and will present that information at the meeting.

Will stated that any Committee members who wish to submit tax package proposals should submit them to the Department of Revenue so that staff will have an opportunity to evaluate the proposals and to compare and contrast them to the existing system.

Committee members should let Will know if they have any outstanding questions that they need data on. Hugh would like to know who is paying the B&O tax -- the B&O tax paid by

consumers versus that paid by businesses. Lisa asked for menus with a few different iterations of sales tax rates, graduated personal income tax rates, etc.

The next Committee meeting will be held from 10:30 a.m. to 2:30 p.m. on Friday, July 12, 2002, at the DoubleTree Inn at SeaTac.